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Wermuth's
Investment Outlook

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Wermuth's Investment Outlook

by Dieter Wermuth*

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1. **The main question investors have these days is whether there are any assets left that offer a reasonable balance between expected return and risk.** Economic growth is slowing everywhere, corporate earnings will suffer correspondingly, stock markets are thus not well supported fundamentally, commodities are still expensive, while yields of good quality sovereign bonds have fallen to extremely low levels – in real terms they are actually negative and could therefore rise again.

2. **What can be done?** I suggest increasing the share of those **emerging markets** in the portfolio which are not too reliant on exports to the OECD area for growth and are financially sound; many of the larger ones are actually in this category. Alternatively, exporters from rich countries which are successful in China, India, Brazil or Russia are good proxies for buying emerging market equities directly. Cement stocks, another idea, are the obvious answer to the large-scale infrastructure and housing programs in that part of the world.

3. **Stocks that provide generous cash flows** – such as utilities, food or chemicals - are another investment theme in the present era of rock bottom yields on high-grade government bonds. Many convertible bonds issued by firms that are likely to survive the present crisis have attractive current yields as well.

4. **Most commodities can safely be shorted on a strong day. The gold price bubble has burst.** I also think it is about time to bet on higher yields of German and French bonds, and lower Italian and Spanish yields. There is one main real estate market which is not overvalued or in free fall: Germany's. It is worth a look.

5. For investors who remain afraid of inflation and want to hedge, how about **inflation linkers** issued by emerging market governments in Brazil, Mexico, Israel and elsewhere? Their average real long-term yield is in the order of 5 per cent, compared to negative yields on US or German linkers.

6. In **foreign exchange**, most countries are aiming for weaker and thus more competitive currencies. The main battle is between the US and China, but most other emerging economies remain net buyers of dollars as well. Japan and Switzerland are trying to stop the further appreciation of yen and franc. Such an environment explains why the euro has not declined more – once the sovereign and banking crises have been resolved, it will actually appreciate.

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* Dieter Wermuth works as a consultant for Wermuth Asset Management GmbH and regularly contributes texts to the HERDENTRIEB weblog which is available on the ZEIT online website.

7. **Following is an overview of the trends that should be driving asset allocations**. In its World Economic Outlook the IMF admits that it had overestimated the strength of the recovery from the recession: while fiscal consolidation is on top of the political agenda almost everywhere, private demand is not "taking the relay" as Olivier Blanchard, the Fund's chief economist puts it. In large parts of the world tight credit, the legacy of toxic assets on bank balance sheets, and overleveraged households continue to suppress the animal spirits that normally would propel economies on a growth path again.

8. **Many of the rich countries are stuck in liquidity traps**, meaning monetary policies are rather ineffective - for households and banks, debt reduction and the repairing of balance sheets via the sale of assets remains the top priority. Japan is everywhere.

Slower growth ahead in the OECD countries

9. **Output gaps are presently getting wider in advanced countries**, not least because governments' austerity programs are front loaded and killing growth. The forecast for German real GDP growth next year, recently published by the top economic research institutes, has been reduced to 0.8 per cent year-on-year – following a growth rate of 3 percent in 2011. In general, since leading indicators of OECD countries are mostly pointing south, new forecasts tend to be more pessimistic than earlier ones.

10. **The consensus estimates for 2012 for the US, the euro area, Japan and the UK are now in the range of 1 to 2 per cent.** Downside risks are larger than upside risks at this point. It looks as if real euro area GDP in the fourth quarter will be somewhat lower than in the third. Growth seems to be slowing considerably in other parts of the OECD region as well.

11. The **widening of output gaps** means that unemployment rates will remain high or even rise again. In spite of the huge expansion of central bank money since the summer of 2007, **inflation rates will thus be heading lower, not higher**. This is good news for investors who benefit from falling inflation rates, or more generally for anybody who is concerned about the purchasing power of savings. On the other hand, business and households who plan to spend more money on investment and consumption can afford to wait in such an environment, thus exacerbating the weakness of global demand and output.

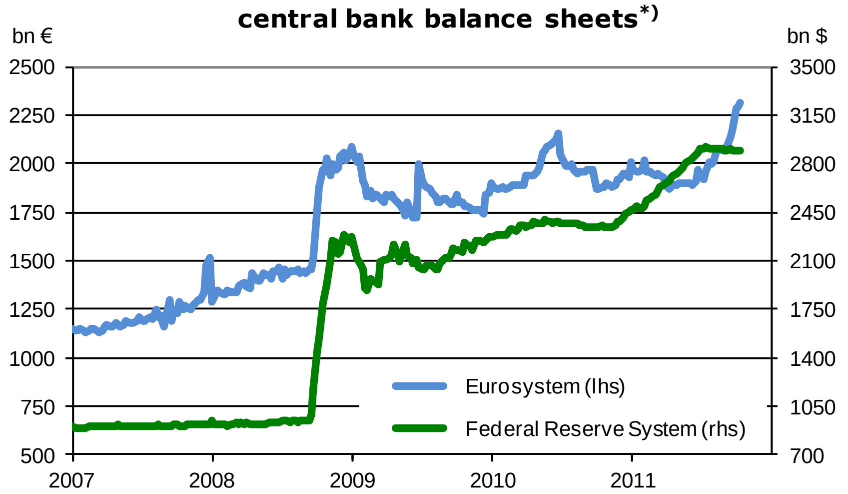
Why low interest rates do not always help

12. In this context, as an aside, when there is **no risk that central bank interest rates will be raised any time soon, there is no incentive to borrow today in order to lock in low interest rates – even though they may be negative in real terms**. The announcement of the Fed that the funds rate will probably remain close to zero for another two years has de facto no additional expansionary effect.

13. There is **another phenomenon related to low interest rates** that is often overlooked but which is of quite some relevance for consumer demand: **in Japan's deflationary environment**, for instance, savers have to increase the amount they put aside for old age, if they have reason to believe that bond and equity yields will not rise again. To achieve a certain annuity the pension pot needs to be larger than they used to assume which means they have to cut back on today's consumption. **In the UK** these days, we see something similar: pensioners are shocked by the sudden and unexpected decline of the annuities they

get from their private sector pension funds - up to 15 percent in a matter of months. This forces them to cut back on spending. Pension providers are currently passing on to their policy holders the reduction of revenues from their portfolio of fixed income securities and the decline of stock prices (This is incidentally a warning to all those who argue in favor of basing a country's entire pension system on income from capital markets). In any case, **we just learn again that low and falling interest rates cannot always be relied upon to stimulate an economy, nor aggressive money printing by central banks.**

central bank balance sheets*)

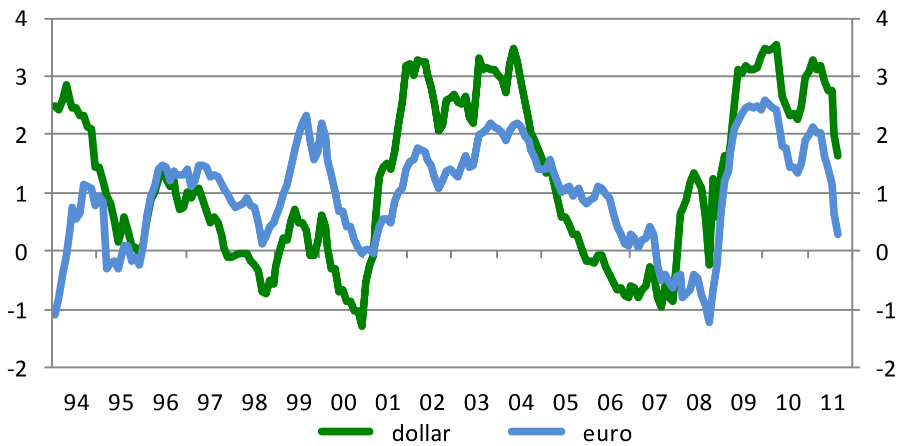


*) total assets

sources: Federal Reserve, ECB

slope of US and euro area yield curves*)

percent



*) 10-year government bonds minus 3-month money market rates

sources: Federal Reserve, ECB, Deutsche Bundesbank

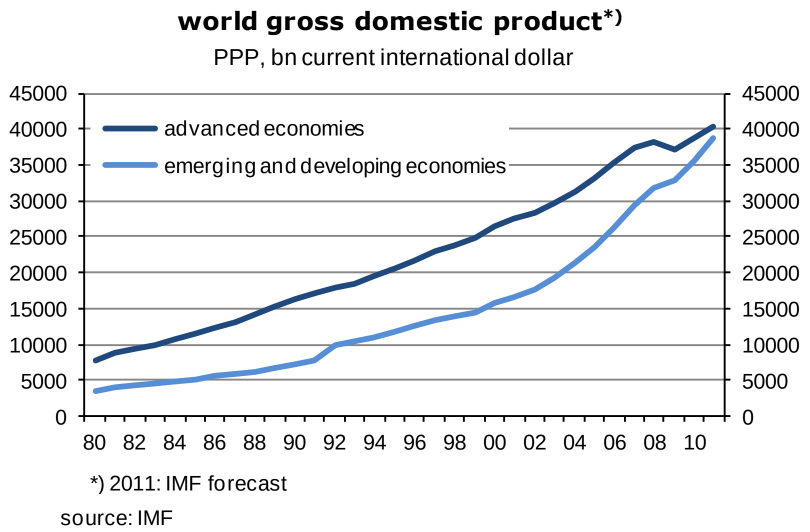
14. Incidentally, some analysts would argue that European and American monetary policies are not as restrictive as suggested by the level of interest rates and the expansion of base money. They can point out that the slope of a yield curve, the difference in percentage points between interest rates at the long end, ten years for instance, and 3-month LIBOR or Euribor is a more reliable indicator of the policy stance of central banks. The steeper the curve, the more expansionary are monetary policies, and vice versa. Using this criterion, both the Fed and the ECB have recently implicitly tightened the reins and thus contribute to the weakening of growth in the two economies. Mario Draghi who takes over as president of

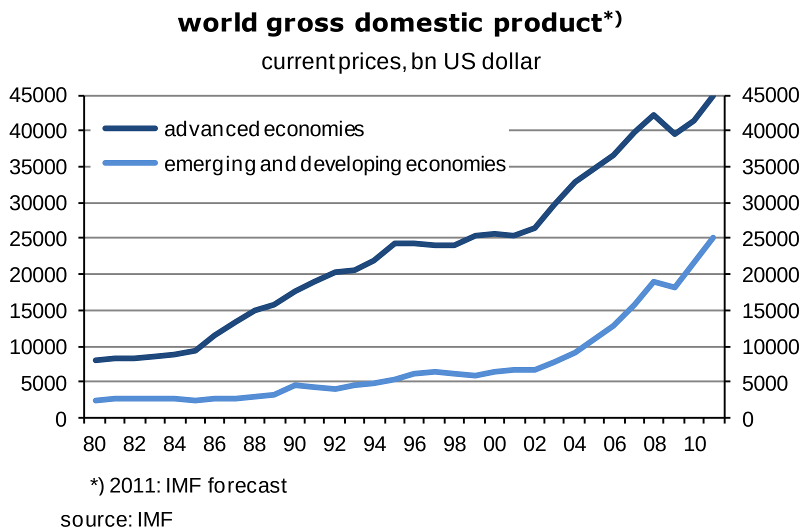
the ECB on November 1 has thus room, and some incentive, to cut the main refinancing rate to 1% or less, from 1.5% today.

Emerging economies still quite resilient

15. **Emerging economies remain the world's growth engines, but even they feel the pinch of the deceleration of activity in the OECD area.** The volume of world trade will increase by about 6 per cent next year, after almost 13 per cent in 2010. So even for these countries, growth forecasts are continuously revised down as well, and actual growth will also be less than potential growth. Inflation rates have peaked. It will no longer be necessary to raise interest rates. The tide has already turned in Latin America. Asia will follow shortly.

16. That said, **output in the region - which accounts for about one half of global output - will still expand strongly in 2012** (% y/y): China 8.6, India 8.0, Eastern Europe 4.0, Latin America 4.1 and Africa and the Middle East 4.6, and emerging and developing economies as a group 6.1 (all aggregated numbers are in purchasing power parity terms). This compares favorably not only with the growth dynamics of advanced economies but also with the "recession" year 2009 when the growth rate of emerging and developing countries fell to +2.8 per cent. Their robust growth and their resilience against shocks are the main stabilizers of global demand today.





First signs of currency wars

17. **One other major problem haunting the world economy, aside from tight fiscal policies and widespread deleveraging, is external imbalances.** They simply do not go away. Countries such as the US, the UK, Italy, Spain or Greece have been running, and are still running, huge balance on current account deficits and thus rely on importing capital. For many years they have been living, for various reasons, beyond their means, even though they are among the world's richest countries and would normally be net capital exporters. They are now overwhelmed by external debt.

18. **Since all of them are also suffering from large budget deficits, their room for manoeuver is very small. To remain creditworthy and able to borrow at low real rates, they are forced to pursue pro-cyclical fiscal and structural policies.** The rating agencies are calling the shots. One way to boost exports and reduce imports is to push back domestic demand. An easier solution to their predicament, one which is neutral in terms of overall demand, would be currency depreciations, but this remedy is not open for this group of countries, with the exception, perhaps, of the UK.

19. Why? **Most of the emerging markets are de facto on a dollar standard and aim to keep their exchange rates more or less undervalued against the US currency**. They want to remain internationally competitive and thus follow the mercantilist, export driven role models of post-war Germany and Japan, and of the Asian tiger countries in the seventies and eighties. Without large-scale dollar purchases their currencies would appreciate because most of these economies are attractive for foreign direct and portfolio investors, aside from running current account surpluses. If they would allow their currencies to strengthen, their current account surpluses would shrink and growth would falter, or so they fear. The fact that the dangerous current account deficits of the US and the European problem countries could at least be partially eliminated if they changed course is not a relevant aspect for these dollar-peggers. Cooperative solutions which are beneficial to both sides are, as always, rare events in an international context. To be sure, the US is also not famously known to be a cooperative player.

20. Since emerging economies are mostly financially sound they actually have more room than they think or pretend. They could actually boost their domestic demand and thus their living standards, at the expense of exports. They are not convinced, though, and would like to postpone the decision until their income per capita is similar to that of the OECD countries. It takes little to notice that economically successful countries are usually running current account surpluses these days. Exceptions are Turkey, Poland, India and Brazil. **For now, external imbalances will thus persist. The longer these developments are allowed to continue, the greater the risk – for everybody.**

Euro area governments forced to find a solution

21. **Inside the euro area**, depreciations of bilateral nominal exchange rates that aim to reduce capital imports and foreign debt are, of course, not possible. To regain creditworthiness and be able to issue government debt at low interest rates, Greece, Italy, Spain, Portugal and Ireland have only one way out – so-called **internal devaluations**. In each case, the conditionality of the European and IMF rescue packages boils down to tighter fiscal policies and lower wage increases than in the other parts of the currency union, in Germany in

particular. Estonia has shown that an internal devaluation can be successful in a relatively short period of time, and Ireland seems to be doing it as well. The others are scared of the deep recessions caused by such crash programs, and prefer to drag their feet.

22. Since Germany pursues fairly restrictive fiscal and incomes policies, the others have to be even more restrictive. These policies pose a huge near-term risk for overall demand in euroland. Unemployment will remain in the order of 10 per cent. Most worryingly, youth unemployment is above 20 per cent. **It is time that a comprehensive solution to the sovereign and banking problems is found.** Solidarity and growth strategies must be the answers, not a repression of demand for all parties involved. This would be suicidal and the end of the euro project. But it is my impression that things are moving in the right direction. The next key date is October 23 – next Sunday.

23. European policy makers have probably arrived at the conclusion that **Greece cannot be saved and that a significant debt reduction cannot be avoided – 1-year government debt now yields a whopping 185%. A haircut of up to 50 per cent** has become a realistic outcome. The fact that the private sector has to participate in the operation implies that banks will take a big hit, and some might default. Their recapitalization requires fresh government money of at least 100 billion euros – 1.1 percent or more of euro area GDP - which, in turn, drives up public sector debt-to-GDP ratios, reduces the creditworthiness of lenders, makes their debt service more expensive, and leads, in a pro-cyclical fashion, to policies that restrict demand for goods and services.

24. Greece is a manageable problem. But it is naïve to believe that the others are on safe ground. For 10-year government bonds, **Portugal** has to pay 11.5% today, Ireland 8.2%. In terms of its finances, Portugal in particular is not so much different from Greece. It will not be possible to pay these high market rates. **Italy and Spain** could just scrape by at yields of 5.9 and 5.4%, but the near-term effects of reducing government spending (especially civil servants' wages) and raising revenue levels in order to bring down debt ratios are extremely painful. The IMF predicts that Italy's GDP will expand by 0.3 percent year-on-year in 2012, and Spain's by 1.1 percent. This already looks like wishful thinking. Both countries are heading for a recession.

25. **Now even France has reached the radar screens of portfolio investors**. It explains the hectic travel schedule of Mr Sarkozy. With a government-deficit-to-GDP ratio of almost 6 per cent this year, followed by perhaps 5 per cent in 2012 - an election year -, an almost structural current account deficit (2.5% of GDP in 2011), disappointing economic growth (the consensus is 0.8 % y/y in 2012), and an unemployment rate of 9.9 per cent it is clear that preserving the cherished status of a triple-A borrower is an almost herculean task.

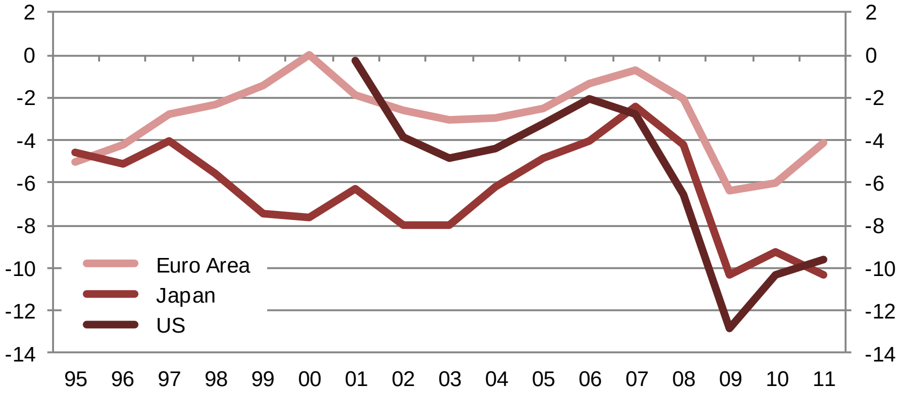
26. Moreover, the main **French banks are valued as if they were close to default**: BNP Paribas has a price to book ratio of 0.56, Société Générale of 0.36, and Crédit Agricole of 0.28. Ratios of well above 1 are normal for well-run banks. Their current year price-to-earnings ratios are at 5 and less. Markets skeptical about France have driven the 10-year government yield spread vis-à-vis Germany (2.1%) to no less than 112 basis points today, the highest for almost twenty years. In the early years of the currency union, 15 to 20 basis points used to be normal.

27. In other words, **the euro area is running out of potential creditors**. My hope is that politicians will rise to the occasion, as they have always done in previous crises. The main

issue is how much fiscal sovereignty countries are willing to transfer to a common institution such as a euro area budget commissioner, if not a euro area ministry of finance or a treasury, in exchange for pooling fully or partially the debt of the 17 member states. For Gaullist France the hurdle is at least as high as for decentralized Germany, the main underwriter.

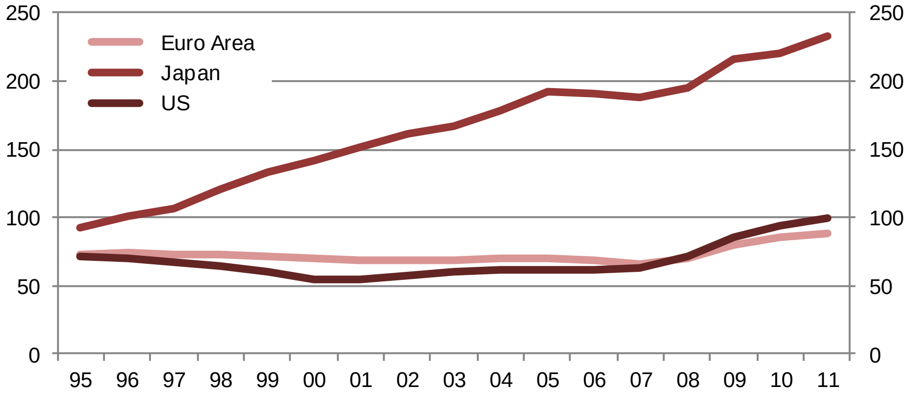
28. **Sensibilities aside, the task looks solvable, but requires a re-writing of the Maastricht Treaty**: the debt-to-GDP ratio of the euro area will be 88.6 per cent this year, the deficit-to-GDP will probably be 4.2 per cent, and the current account-to-GDP ratio -0.5 per cent. All this is better than the comparable statistics for the US, Japan or the UK (except for Japan's balance on current account - which shows a huge surplus).

fiscal balances
percentage of GDP



source: IMF

general government debt
percentage of GDP



source: IMF

29. If a solution is finally found, or even if the heads of states and governments succeed only in outlining how a solution could look like, a major appreciation of the euro and a dramatic narrowing of euro area yield spreads can be expected. The growth outlook would improve as well.

Likely effects on the euro and on euro area bond yields

30. **Such a benign outcome would be a great relieve for the rest of the world, but it is doubtful whether this is enough to get the global economy back on track again. For the foreseeable future, it will continue to slow**, following leading indicators which are all pointing down. On the other hand, the outlook for inflation could not be better, now that the increase in output gaps, combined with stubbornly high unemployment, is pushing down prices on the early stages of value added chains. Consumer price inflation has peaked everywhere and will probably fall for several quarters.

31. **For investors who hold Swiss, Japanese, US, German, British, Dutch or Scandinavian government bonds these have been happy times** as yields have fallen to levels lower than anybody can remember. The product of capital gains and current yields has been in the order of 10 per cent since the beginning of the year. Demand for these bonds has not only been boosted by stable and low inflation expectations but also by a flight to safety – there are not many governments outside this group of countries which are considered to be solid credits.

32. Using actual consumer price inflation rates, **real yields of these bonds** in the 10-year range vary actually between very negative (US, UK, Finland, Germany), negative but close to zero (Netherlands, Sweden, Denmark) and positive but less than 1% (Switzerland, Japan, Norway). Such is the desperation of investors these days.

33. **They feel they are running out of attractive alternatives and must prepare for much lower returns than in the past**. The recent rebound of bond yields in recent weeks is not a prelude to considerably higher yield levels but rather a normalization - as the likelihood of a comprehensive euro rescue program has increased somewhat. Nominal and real yield levels in the bond markets listed above will remain depressed for the foreseeable future. Investors are almost forced to shift a larger portion of their funds into riskier assets, especially into assets of emerging economies where growth is still robust, into bonds of the European periphery, or into convertible bonds.

Emerging economies to the rescue

34. **The gloom is probably overdone. After all, the world economy is still growing at an annual rate of almost 4 per cent this year and next.** The likelihood of a global recession or something even worse is still less than 50 per cent. Emerging markets are mostly financially sound and can thus spend their way out of any shortfall of export demand while the euro area will successfully step up its efforts to ring fence shaky banks and sovereigns. The US, Japan and Britain will remain in deleveraging mode and grow very slowly but will not fall back into deep recessions, thanks to a deluge of liquidity and near-zero interest rates.

35. At this point, **the cheapest emerging market by far is Russia**. The price-to-earnings (p/e) ratio of the main stock indices on the basis of this year's estimated earnings per share is just 5.0 while the market value of the firms in the stock indices is only 92 per cent of their book value, a highly unusual situation. It is more typical of a frontier market such as Iran rather than of middle-income Russia. Endemic corruption, the centralization of political and economic power, arbitrary changes of laws and regulations, a run-down infrastructure, the recent acceleration of capital flight and a relatively low growth rate for a country in catching-up mode are an unfavorable mix that keeps investors away.

36. In equally commodity-rich countries such as Australia, Canada, Saudi Arabia or South Africa p/e ratios are twice as high, or higher. This means that **Russian firms pay at least two times more in real terms for their (equity) capital than global peers**. Small wonder that the investment ratio of the country is about half as high as China's.

37. The main reasons why **Russia is still a good place for value investors** are these bombed-out valuations, the impression that things cannot get much worse, that at least some overdue reforms are on their way, especially in the electricity sector that badly needs modernization, and last but not least the fact that Russia is the major producer of energy and non-energy commodities. China, globally the main consumer of these products, is next door and growing fast. So far, only 6.6 percent of Russia's exports go there, compared to 38% for the euro area. These numbers will change dramatically in coming years.

38. The country's medium-term real GDP growth rate of 4 per cent annually may be somewhat disappointing, but the momentum is still considerably stronger than in the West. The gap in income and wealth vis-à-vis the euro area and the US is steadily getting smaller. **Investment opportunities in utilities, (some) banks or retail trade look attractive.**

China will continue to achieve brisk economic growth

39. **China is by now the country that makes or breaks the global business cycle**. At current exchange rates, its nominal GDP will be about $7.2tr this year, compared to America's $15.1tr and the euro area's $13.1tr. Since the economy is growing so fast, the increase of nominal GDP this year, expressed in dollar terms, is larger than that of the world's two largest economies combined. On present trends, China's economy will overtake the US before the end of the decade. The emphasis is on "present trends"! Can China actually uphold its growth momentum?

40. In terms of indicators such as the investment ratio, productivity trends, size of the potential market, pent-up consumer and infrastructure demand, exposure to foreign markets and competitiveness **there is little doubt that (real GDP) growth can indeed continue at rates of almost 10 per cent a year.** The management of the economy has been quite skillful so far. Even though the government is very much in control, it leaves plenty of room for small and medium-sized firms, many of which have de facto become multi-nationals. The manufacturing base is very broad by now, and production is increasingly sophisticated. Another plus is that there are several commercial centers – Shanghai and Shenzhen are more important than Beijing. Competition among regional governments is intense.

41. The main worry of Chinese policy makers has been inflation this year. Consumer price inflation had increased from -1.8% y/y in the summer of 2009 to +6.5 y/y last July. It has now fallen to 6.1% in September, almost in lock step with producer prices. Since the inflation outlook is rather positive – because of lower commodity and food prices and, more generally, because of the new weakness of global demand - the **central bank has stopped tightening and has begun to inject net liquidity**. Lower reserve requirements for banks are about to follow. Third quarter real GDP has been +9.1% y/y, after 9.5% in Q2. Industrial production is in the order of 13½% y/y this fall. All this looks very strong.

42. An economy that is racing ahead at such rates – even in 2009 growth was no less than 9.2%! – could make consumers and investors so optimistic, if not exuberant, that a misallocation of resources and asset price bubbles could almost be expected. **The Chinese growth**

process is certainly not smooth, but there are no signs that it may be hitting a wall. Urbanization continues apace and the structural housing shortage will not soon give way to an oversupply. Importantly, mortgage loan-to-value ratios are much lower than in most OECD countries; the risk is therefore small that millions of households will be faced with negative net equity when house prices start falling some day.

43. **Chinese banks have their books probably full of non-performing loans after the lending boom of 2008 to 2010**. Property developers and local governments had increased their annual borrowings to the tune of 35% y/y during that period. Not all of that money had been wisely invested, but it seems that banks are able to cope: their cash flows remain sound, not least because of brisk economic growth, interest margins are wide and almost guaranteed, and the government has the means to come to the rescue if needed.

44. On balance, this is very reassuring for commodity producers and exporters of consumer and capital goods in the rest of the world – they had been wondering who might replace the American consumer as spender of last resort. They need not worry. The role has already been filled by the 1.34 billion Chinese.

India wants to become an economic giant as well

45. **India which is almost as large in terms of population (1.16bn) is not quite as successful economically.** Nominal GDP per capita is only about one third that of China, and the share in world exports is just 1.3 percent, compared to China's 12.2 per cent. But the country is also growing very fast (7.6 % y/y in 2011), driven more by consumer demand and foreign trade than by capital spending, and is already one of the most important markets. Fighting inflation remains a priority given that consumer prices are more than 9 per cent higher than last year. Policy rates continue to be raised but remain slightly negative in real terms. The turning point in monetary policy is near, though, as output growth is slowing – industrial production was just 4.1% y/y in August.

46. **The country is financially not as healthy as China**: since both the balance on current account and the government budget are in deficit, the rupee has lost more than 10 per cent against the dollar over the past year. And stocks are not cheap, in spite of the 19 per cent decline from their historical high in November 2010. The price-to-earnings ratio is around 15 and thus about three times higher than Russia's while the price-to-book ratio is no less than 2.8. A lot of good news had been priced into stocks, more than India had been able to deliver.

47. While Indians like to call their country the world's largest democracy, **structural problems remain quite serious.** Illiteracy, while declining rapidly, is still in the order of 26 percent, the income distribution is extremely uneven, the road network totally inadequate. According to Transparency International's corruption index, India is ranked number 87 out of the 178 countries surveyed. Could be better! Of the other three BRIC-countries, Brazil is no. 69, China no. 78, and Russia no. 154. On the World Bank's updated scale which measures the ease of doing business in a country, India is also far down the list: no. 132 out of 183. The bureaucracy is overwhelming. Just try to get a tourist visa – a nightmare!

48. On the other hand, there are of course **some pockets of excellence** such as the IT industry, air transportation or telecommunications. English is the lingua franca, a big plus. And with China as the admired role model and competitor for supremacy in Asia, reforms are

accelerating. There are now even talks about free trade with Pakistan, the old enemy. On balance, India is the catching-up story par excellence.

Brazil takes a break

49. Finally Brazil, the fourth of the BRIC-countries. It has a population of about 200 million, with a per capita income of $11,500, about the same as Russia's, and three times higher than China's. It is thus a middle-income country. **The trend growth rate of real GDP of almost 4½ per cent** confirms the impression that Brazil's economy is chugging along at a moderately rapid pace. Under the assumptions that growth will continue at a rate of 4½ per cent, and that Germany will grow at 2 per cent a year, it will take Brazil 52 years to catch up.

50. **Surprisingly, it is not easy to do business in Brazil** – on the World Bank's scale from 1 (Singapore) to 183 (Chad), it ranks 126th, a little better than India (132), but behind Russia (120) and China (91). Investors complain about the tax system, problems resolving insolvencies and enforcing contracts, and dealing with construction permits.

51. More near-term, real GDP will expand by only about 3½ per cent both this year and next. The risk seems to be on the downside, though - industrial production has stagnated for 18 months now and real GDP has probably shrunk between the second and third quarters, seasonally adjusted. But there is still full employment. **The central bank has begun to lower policy interest rates. At 11.5% they are still high compared to inflation (CPI 7.3% y/y). The inflation target is 4.5 per cent.**

52. The country is quite dependent on commodity prices, if not as much as Russia, being one of the main producers of food, metals and oil, and thus suffers from recent price declines. Oil reserves, many of them offshore, have lately been revised up significantly. **The main stock index is down by about a quarter from the last high in November 2010** which has brought down the p/e ratio, using expected 2011 earnings, to 9.6 which is about twice the Russian level. As to the currency, it is floating and since the fall of 2002 on a long-term appreciating trend against the dollar. Recently, in the wake of falling commodity prices, it has lost some ground.

53. Both the government budget and the balance on current account are in the red to the tune of 2½ per cent of GDP this year. In spite of this and the various difficulties listed by the World Bank, **Brazil remains a popular destination for direct and portfolio investments**. One reason is that it is a stable democracy where government changes take place in a civilized way.

Conclusion: the world economy falls into two distinct parts

54. **On the one hand slow-growing rich countries**, teetering on the brink of recession, with major sovereign and banking risks which have pro-cyclical, ie negative effects on final demand, but with low inflation, very low real bond yields of high-grade borrowers, very high yields of over-indebted sovereign borrowers, extremely expansionary but ineffective monetary policies as counterweights to restrictive fiscal policies. Companies are mostly cash rich but hesitate to increase capital expenditures – they expect a weakening of final demand and lower profits.

55. **On the other hand developing and emerging countries which continue to expand briskly, if somewhat below trend**. It is still difficult for them to uncouple from developments in the rich countries and commodity cycles – with the major exception of China. Even so, their real GDP growth rate will be about 5 per cent in 2011, or more than five times higher than that of the OECD area. Inflation in this part of the world is still well above national targets but has probably peaked. Central banks use this to ease policies again. Since catching-up processes will continue for several decades, emerging economies are the destinations of choice for portfolio investors.